

**While Most Taxpayers Received Accurate and
Timely Notification of Their Advance Refunds,
Millions Did Not**

October 2001

Reference Number: 2002-40-016

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 24, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - While Most Taxpayers Received Accurate
and Timely Notification of Their Advance Refunds, Millions Did
Not (Audit #200140047)

This report presents the results of the initial phase of our reviews of the advance refund provisions of H.R. 1836, also known as the Economic Growth and Tax Relief Reconciliation Act of 2001.¹ In this initial phase, our overall objective was to determine whether the Internal Revenue Service (IRS) would timely and accurately notify taxpayers about their advance refunds. We plan to continue the review of advance refunds to determine how well the IRS addresses any consequences resulting from the issued advance refund checks and notices and how well the IRS handles the processing of the advance refund amounts during the 2002 Filing Season.

In summary, the IRS developed an extensive plan, implemented new computer programming, and hired a private vendor to print and mail more than 120 million advance refund notices. This was a significant accomplishment that was performed in a very limited time. However, we identified two problems that affected the calculation of the advance refunds and the timely issuance of the advance refund notices.

The IRS did not accurately calculate the advance refund amount for some taxpayers. We alerted the IRS to this condition on July 3, 2001. The IRS timely addressed this condition, which included changing computer programming. For all returns processed as of July 5, this change prevented at least 535,000 taxpayers from receiving advance refunds totaling at least \$117.6 million more than the amount allowed by law. However, the IRS' initial mailout included advance refund notices that reflected amounts greater

¹ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

than the taxpayers would receive. At the time we identified the error, these notices had been printed and prepared for mailing as part of the initial mailing of 112 million advance refund notices.

In addition, 5.3 million taxpayers who timely filed their tax returns would have delays from 1 to 9 weeks in receiving their advance refund notices. These delays were due to the way the IRS processed timely filed returns received with payments that fully paid the amount owed and the way programming was developed to generate advance refund notices.

To address the computer programming problem in calculating the advance refund, we recommended that the IRS correct the programming, issue corrected advance refund notices to affected taxpayers, issue a press release informing the public that advance refund notices with incorrect amounts were sent out, and update its Customer Service procedures. In response, the IRS promptly adopted our recommendations.

To address the 5.3 million delayed advance refund notices, we recommended the IRS inform its employees and issue a press release to advise taxpayers about the advance refund notice delays. In response, the IRS issued a news release to the public and updated its internal procedures informing employees of the notice delays. We also recommended that the IRS change the programming used to generate the advance refund notices to prevent additional delays. However, the IRS responded that, to help minimize the risk of any errors occurring, the programming would not be changed. We understood the potential for error and accepted the IRS' reason for not changing the programming.

Management's Response: While management informally responded to our issues during the audit, they did not provide a formal response to this report. Management's response was due on October 18, 2001. As of October 21, 2001, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Stan Rinehart, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (972) 308-1670.

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Background

On June 7, 2001, H.R. 1836,¹ also known as the Economic Growth and Tax Relief Reconciliation Act of 2001, was signed into law. This legislation required advance refunds² to be issued as rapidly as possible to all taxpayers who reported income taxes for Tax Year (TY) 2000. According to Department of the Treasury estimates, the advance refund provision will provide over 90 million taxpayers with approximately \$39 billion in advance refunds.

To minimize confusion and limit the number of taxpayer inquiries, the Internal Revenue Service (IRS) is mailing advance refund notices to more than 120 million taxpayers. The first 112 million advance refund notices were issued by July 17, 2001. The remaining notices will be mailed out weekly through December 2001, as additional returns are processed.

- Notice 1275 is being mailed to notify over 90 million taxpayers that they are eligible to receive an advance refund. These notices describe the amount of the advance refund check, the week the check will be issued, and the possibility of an offset for an outstanding government debt.
- Notice 1276 is being mailed to notify over 30 million taxpayers that they are ineligible to receive an advance refund.³

The advance refunds should be mailed as rapidly as possible and, to the extent practicable, before October 1, 2001. Generally, the last two digits of the taxpayer's Social Security Number (SSN) determine when the advance refund check is mailed, so an individual may get a check at a different time than a neighbor or family member.

¹ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

² Also known as tax rebates, 2001 advance payments, 2001 advance credits, and tax relief.

³ Taxpayers will not be eligible if (1) they had no income tax liability on their TY 2000 return, (2) they could have been claimed as a dependent on someone else's return, or (3) they were a non-resident alien.

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The Internal Revenue Service Rapidly Implemented the Advance Refund Provisions

The audit was conducted at the IRS National Headquarters during June and July of 2001 and in accordance with *Government Auditing Standards*. Detailed information of our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS timely addressed the advance refund provisions in H.R. 1836. The IRS developed an extensive plan and implemented new computer programming to issue advance refund notices and refunds. This significant accomplishment was performed in a very limited time.

The IRS planned to inform all taxpayers (over 120 million) about their advance refunds prior to issuing the refunds. This notification was to minimize the number of taxpayer inquiries and the resultant adverse effect on other IRS programs. The IRS hired a private vendor to facilitate the printing and mailing of the advance refund notices. Within 6 weeks after the legislation was signed, the IRS issued over 112 million notices to inform taxpayers of their advance refund eligibility. The remaining notices will be issued weekly through December 2001, as additional returns are processed.

The IRS developed a methodology and the programming to calculate the advance refund amount. The programming took into consideration most of the advance refund provisions as stated in the legislation. The IRS coordinated with other government agencies to timely issue paper checks to taxpayers.

The IRS accurately and timely notified most taxpayers of their advance refunds; however, two problems prevented millions of taxpayers from receiving accurate and timely notification.

The Advance Refund Amount Was Not Accurately Calculated for Some Taxpayers

Although the advance refunds are for taxes paid for TY 2001, the advance refunds are calculated based on TY 2000 return information. The minimum refund amount is \$1, while the maximum amount depends on the taxpayer's filing status. These maximums are \$300 for taxpayers filing as single or married filing separately, \$500 for taxpayers filing as head of household, and \$600 for

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taxpayers filing jointly or as a qualifying widow(er). Based on these limitations, the refund will be the lesser of:

- Five percent of the taxable income from the TY 2000 return.
- The net income tax from the TY 2000 return after subtracting non-refundable credits such as the credit for child and dependent care expenses, child tax credit, credit for the elderly, and education credit.

The IRS did not accurately calculate the advance refund amount for some taxpayers. Advance refund amounts were not limited to the net income tax after credits when the IRS calculated the maximum amount based on the taxable income. This calculation error gave some taxpayers the maximum amount allowable by law when they were actually entitled to a lesser amount.

We informed the IRS of this error on July 3, 2001, and the IRS was able to timely address this programming problem before any advance refunds were issued. For returns processed as of July 5, 2001, this prevented at least 535,000 taxpayers from receiving advance refund overpayments totaling at least \$117.6 million. Correcting the error also prevented additional overstated refunds for returns processed after July 5.

Although the IRS addressed the programming error, approximately 523,000⁴ incorrect notices were issued to taxpayers informing them that they would receive the maximum refund amount, when in fact they would now receive a lesser amount. At the time we identified the error, these notices had been printed and prepared for mailing as part of the initial mailing of the 112 million advance refund notices.

⁴ The initial IRS computer run to print the advance refund notices resulted in 523,000 incorrect notices. Three weeks after this run, we determined the number would have grown to 535,000 had we not identified the problem. The difference of 12,000 (535,000 less 523,000) represents affected returns in the additional volume of tax returns processed during the 3 weeks.

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IRS management indicated human error caused this programming error to go undetected. The programming was tested during the quality review process, but this process only verified that the computer output matched the programming logic. The process did not verify that the programming logic was in accordance with the requirements of the law.

Recommendations

1. We recommended that the IRS correct the programming for calculating the advance refund amount.

Management's Response: During the review, IRS management informed us they had made timely programming changes to address this condition. The IRS did not respond formally to this report. Management's response was due on October 18, 2001. As of October 21, 2001, management had not responded to the draft report.

2. We recommended that the IRS issue corrected notices to the taxpayers who were issued incorrect advance refund notices.

Management's Response: The IRS informed us that corrected notices would be issued to these taxpayers.

3. We recommended that the IRS issue a press release stating some advance refund notices contained incorrect advance refund amounts.

Management's Response: The news media reported this problem within days of the Treasury Inspector General for Tax Administration informing the IRS of this condition.

4. We recommended that the IRS issue instructions to Customer Service telephone assistants on how to handle this incorrect notice condition.

Management's Response: The IRS updated its Customer Service procedures to include information on the 523,000 notices with incorrect advance refund amounts.

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An Estimated 5.3 Million Taxpayers Who Filed Timely Returns Will Have Delays in Receiving Their Advance Refund Notices

The IRS' initial mailout of 112 million notices did not include 5.3 million advance refund Notices 1275 for taxpayers who filed timely returns in April 2001 with payments for the full amount indicated as owed. Consequently, these 5.3 million taxpayers would have delays ranging from 1 to 9 weeks in receiving their notices. The IRS was to issue the advance refund notices as early as possible to reduce the number of taxpayer advance refund inquiries to the IRS. Taxpayers who filed timely returns would expect to receive their notices during the initial notice mailout.

The delays, which prevented taxpayers from being timely notified of their advance refunds, may result in additional calls to the IRS from taxpayers wanting to know when they will receive their advance refunds. These additional calls will reduce the access to customer service, which has already been adversely affected because of the dramatic increase in calls concerning advance refund issues. The notification delays resulted from a combination of two reasons.

- The first reason was that the IRS defers processing tax returns received with payments⁵ that fully pay the amount of tax owed to help ensure refund returns are timely processed.
- The second reason involves the computer programming⁶ designed to generate the advance refund notices. Rather than mailing the notices when the IRS processed the tax returns, the IRS would stagger the mailing according to a 10-week schedule, with the notices being mailed just prior to the related advance refund checks. The 10-week schedule was based on the last 2 digits of the taxpayers' SSNs.⁷ Although the advance refunds had to be

⁵ The IRS does give priority to processing the payments.

⁶ The programming to generate advance refund Notice 1275 for returns processed from June 21, 2001, to August 30, 2001.

⁷ Taxpayers having SSNs ending in "10" to "19" would have their notices mailed in week 2, causing a 1-week delay. Taxpayers having SSNs ending in "90" to "99" would have their notices mailed in week 10, causing a 9-week delay.

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staggered because a maximum of 11 million advance refund checks could be printed and mailed each week, we are not aware of any reason the mailing of related notices had to be staggered.

Recommendations

5. We recommended that the IRS issue a press release to inform taxpayers who filed returns paying the amount indicated as owed that they might have delays in receiving their advance refund notices.

Management's Response: The IRS issued a news release explaining how returns with payments are processed and that some taxpayers might have their notices delayed.

6. We recommended that the IRS inform its employees that some taxpayers might have advance refund notice delays so employees would be aware of the notice delay condition.

Management's Response: The IRS updated its Customer Service procedures notifying employees of this condition.

7. We recommended that the IRS change the programming used to generate advance refund Notice 1275 so that the IRS would mail the notices when the tax returns are processed rather than according to the 10-week schedule.

Management's Response: The IRS responded that, to minimize the risk of any errors occurring, the programming would not be changed.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Internal Revenue Service (IRS) would timely and accurately notify taxpayers about their advance refunds.

- I. We determined if the IRS calculated the advance refund amount correctly.
 - A. We evaluated the documentation for the computer programming used to calculate the advance refund amount for logic errors. After determining there was a computer programming logic error, we performed the following analyses to determine the number of affected taxpayers and the total dollar amount involved.
 - B. We obtained a computer extract from the IRS Masterfile that contains tax accounts for taxpayers who file Individual Income Tax returns. We analyzed the entire extract to determine the number of taxpayers that would have been affected by the IRS computer programming error. This included approximately 535,000 accounts that would have had potentially incorrect advance refund credits. This figure was higher than the 523,000 figure identified by the IRS because our extract used an additional 3 weeks of return processing data.
 - C. We took a limited interval sample of 200 accounts from the 535,000 to verify that the IRS programming had been corrected by reviewing the associated return information on the Integrated Data Retrieval System.
 - D. We determined the dollar effect by which the advance refund credits would have been overstated if the IRS had not been able to timely correct its computer programming.
 - E. We validated the computer extract data. We took a limited interval sample of 120 accounts and verified the data against the source data on the IRS Masterfile. We also conducted various tests to ensure the reasonableness of the data.
- II. We determined whether the IRS effectively implemented the process for timely mailing advance refund notices.
 - A. We discussed the implementation process with an IRS executive.
 - B. We analyzed the IRS schedule and computer programming documentation for generating and mailing the advance refund notices and checks.
 - C. We estimated the number of taxpayers who timely filed returns with payments that fully paid the amount indicated as owed that did not have a timely advance refund Notice 1275. Our estimates used IRS inventory reports for processing year 2001 through July 26, 2001, and the related volumes for both advance refund Notice 1275 and advance refund Notice 1276.

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Appendix II

Major Contributors to This Report

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Bonnie Shanks, Auditor

Steven Stephens, Auditor

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Appendix III

Report Distribution List

Commissioner N: C
Deputy Commissioner N: DC
Chief Counsel CC
Senior Advisor to the Office of the Commissioner N:DC
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
National Taxpayer Advocate TA
Office of Management Controls N:CFO:F:M
Audit Liaison:
 Commissioner, Wage and Investment Division W

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact any corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; at least 535,000 taxpayers would have received advance refund overpayments totaling at least \$117.6 million had the programming error not been identified and corrected (see page 2).

Methodology Used to Measure the Reported Benefit:

This amount represents the excess dollar amount of advance refunds that would have been issued had the programming error not been corrected. The Treasury Inspector General for Tax Administration's Office of Information Technology staff provided us with an Internal Revenue Service (IRS) Masterfile extract. They used criteria designed to identify accounts that would have been affected by the erroneous programming. We identified all 535,000 accounts meeting the criteria out of the 119 million returns processed by cycle 200128.¹ These 535,000 accounts would have had advance refunds overstated by at least \$117.6 million had the programming not been corrected.

Type and Value of Outcome Measure:

- Taxpayer Burden – Actual; approximately 523,000² advance refund notices with incorrect advance refund amounts were issued to taxpayers (see page 2).

Methodology Used to Measure the Reported Benefit:

This amount represents the actual number of erroneous advance refund notices (out of 112 million in the initial mailout) that were mailed to taxpayers. The IRS provided the number of taxpayers that received an incorrect notice.

¹ A cycle is 1 week's processing at the processing centers and is expressed as a six-digit code. The first four digits are the calendar year of processing. The last two digits are the processing week in that year.

² The initial IRS computer run to print the advance refund notices resulted in 523,000 incorrect notices. Three weeks after this run, we determined the number would have grown to 535,000 had we not identified the problem. The difference of 12,000 (535,000 less 523,000) represents affected returns in the additional volume of tax returns processed during the 3 weeks.

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Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 5.3 million taxpayers would have delays ranging from 1 to 9 weeks in receiving their advance refund Notice 1275 (see page 5).

Methodology Used to Measure the Reported Benefit:

The 5.3 million represents the estimated number of taxpayers who will receive their advance refund Notices 1275 from 1 to 9 weeks after cycle 200127 processing, which would be after July 17, 2001. Coincidentally, the initial mailing of 112 million notices for returns processed as of cycle 200125, and the notice mailing for returns processed in cycles 200126 and 200127, had July 17 as the mailing completion date. IRS reports showed that approximately 7 million timely filed returns received with payments that fully paid the amount indicated as owed had not been processed in time to be included in the initial mailing of 112 million notices. The 5.3 million was determined by subtracting, from this 7 million figure, an estimated 1.7 million returns consisting of:

- An estimated 1.2 million taxpayers who would receive advance refund Notices 1276. We excluded the 1.2 million because the IRS did not stagger Notices 1276.
- An estimated 500,000 taxpayers who were mailed Notices 1275 by July 17, 2001. This includes those taxpayers whose returns were processed during cycles 200126 and 200127 and whose related Social Security Numbers ended in “00” to “09.” Taxpayers with Social Security Numbers ending in “10” to “99” would have had their Notices 1275 staggered, creating the 1- to 9-week delays.

We provided the IRS with specific details as to how we arrived at the 1.2 million and 500,000 figures.